

# Independent Sponsor Series:

## Company Control Absent a Controlling Interest

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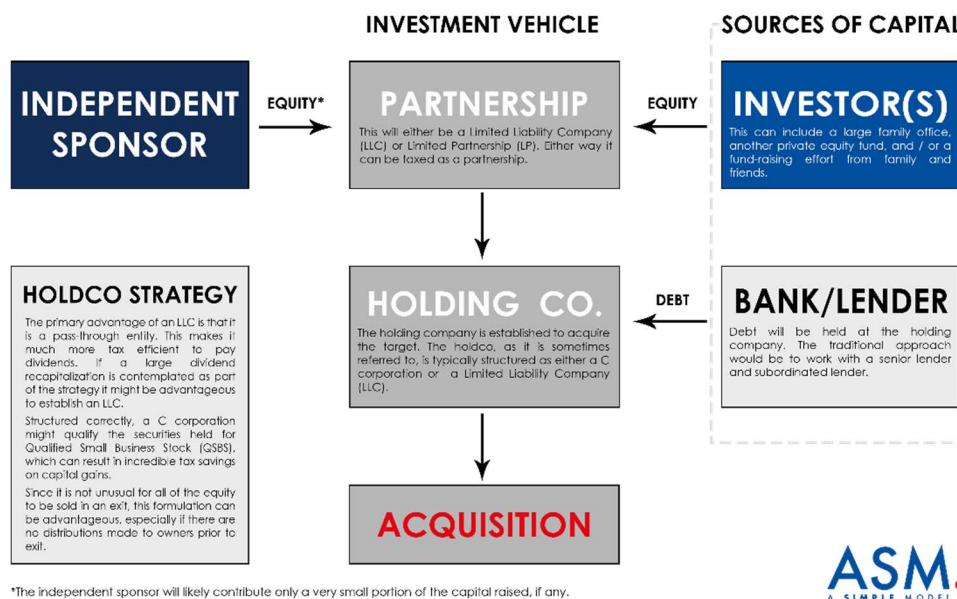
## **Katten**

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### Independent Sponsor: Company Control Absent a Controlling Interest

As it relates to corporate governance, equity ownership is often associated with control. But private equity transactions can be structured to provide an independent sponsor with full control of a business regardless of the amount of capital contributed. This is accomplished via a partnership agreement, which, per the image below, can be structured as either a Limited Liability Company (LLC) or a Limited Partnership (LP).

For the purpose of this post, we will use an LLC because it is a common approach for independent sponsors. This LLC will serve as the investment vehicle for the deal, and the associated LLC operating agreement will govern how the independent sponsor and investor(s) work together.



Before exploring the specific language that places control in the hands of the sponsor, we thought it would be helpful to first define an LLC and an LLC operating agreement.

#### What is an LLC?

A limited liability company (LLC) is a business structure. In addition to limiting the liability of its owners, which are called members, the primary advantage of an LLC is that it is a pass-through entity. Pass-through entities, which include LLCs, Limited Partnerships and S corporations taxed as partnerships, are not subject to income tax. Instead, the individual owners are responsible for taxes due.

This can be attractive for private equity investments if the intention is to make distributions throughout the hold period. In contrast, with a corporation, profits are first taxed at the corporate level and then taxed a second time when those profits are distributed to shareholders.

LLCs are popular in private equity transactions because they are easy to establish and because they offer a lot of flexibility for different equity structures.

## What is an LLC Operating Agreement?

The LLC operating agreement outlines in detail how the members will interact to guide the financial and operational objectives of the LLC. LLC operating agreements can vary from one transaction to the next, but most will cover the topics outlined below.

1. Organization: The basic information describing how the entity is structured. This section includes details that cover the name of the entity and its purpose.
2. Membership Interests: This covers the member's ownership interests. If the structure calls for different classes of membership interests, they will be described in this section. This section will also reference an exhibit listing all of the members and their respective ownership on the date of formation.
3. Management: This covers the management of the LLC.
4. Indemnification: The LLC will agree to indemnify any member or manager for liabilities and losses incurred related to the LLC.
5. Taxes: This covers tax reporting requirements and tax elections.
6. Books and Records: This details the financial reporting requirements of the LLC and the maintenance of books and records.
7. Allocations and Distributions: This covers distributions of cash and the allocations of profits and loss to members.
8. Transfers: This informs members of the limitations surrounding transfers of membership interests.
9. Dissolution and Liquidation: This covers the process and approval required for any dissolution or liquidation proceeding.
10. Provisions Relating to Members: This covers the rights and obligations of the members of the LLC.

For a private equity control transaction, the LLC operating agreement will typically run between 50 or more pages in length. In this post we will only reference language specific to control and voting rights.

## Independent Sponsor Company Control

Absent a majority equity stake, gaining control of the business requires gaining control of the board and structuring the LLC as a manager-managed LLC (i.e., board-managed LLC). From the list above, the third and tenth bullets are most relevant to this process. Starting with the third bullet, below you will find hypothetical language detailing how the managers of the LLC would exercise "full control over all activities of the LLC."

ARTICLE [X]

MANAGEMENT

[X].1 Authority.

(a) Except as otherwise expressly provided herein, the Board shall conduct, direct and exercise full control over all activities of the LLC. All management powers over the business and affairs of the LLC shall be exclusively vested in the Board and the Board shall have the sole power to bind or take any action on behalf of the LLC, or to exercise any rights and powers granted to the LLC under this Agreement or any other agreement, instrument, or other document to which the LLC is a party. No Manager shall have the authority to bind the LLC, unless the Board has granted such authority to such Manager.

Per the example LLC operating agreement language, this article puts control of the LLC in the hands of the board. With this structure, the non-managing members do not have a say in the management of the business, but they remain entitled to their economics via their respective membership interests. Because LLCs are based on contracts, you can draft the contract so that the managing member has control even though he or she does not own a majority of the economics of the LLC. You can also get the same result in a limited partnership by designating the general partner.

The section that follows “Authority of the Board” in the LLC agreement will list the active board members of the LLC, describe how long each board member can serve, and detail how vacancies are filled, among other things. This language also changes from one LLC agreement to the next, but you will generally find that the following is covered.

1. **Number of Board Members and Appointment:** The number of managers that will serve on the board, and the names of the managers that will serve as of the effective date.
2. **Term:** The term served by each manager, and the process for resigning from said role.
3. **Removal:** Approval required to remove a manager.
4. **Vacancies:** How board vacancies are filled.
5. **Reimbursement:** The LLC’s responsibility to reimburse costs and expenses incurred by each manager in connection with each manager’s role in managing the LLC.

The voting rights of the members are then directly addressed in a separate article.<sup>1</sup> In this example, and per the bulleted list above, the language would be found under “Provisions Relating to Members” (depending on the LLC agreement, this might also read “Rights and Obligations of Members,” or some variation of that language).

ARTICLE [X]

PROVISIONS RELATING TO MEMBERS

[X].[X] No Other Voting Rights.

Except as otherwise expressly provided in this Agreement, no Member shall have any voting rights or rights of approval, consent or veto or similar rights over any actions of the Company.

The language associated with member rights and obligations can get a lot more detailed. It might include language covering a “Lack of Authority,” for example, which would clarify that a member cannot bind the LLC to any contractual obligation. For the purposes of this post, however, “No Other Voting Rights” is sufficient to communicate how the LLC agreement is structured.

Generally, members do not have management authority unless the LLC operating agreement grants them that authority. In addition, you can limit voting rights for your members to specifically negotiated items or give them no voting rights. In a corporation, on the other hand, you do not have the same level of flexibility.

### **Independent Sponsor Investor Base**

Achieving board control is largely dependent on the independent sponsor’s ability to negotiate with investors. If the independent sponsor partners with a private equity firm to fund the transaction, it may make

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<sup>1</sup> Often times, the LLC Operating Agreement will provide for different classes of equity for the purpose of ensuring Board representation or control by the independent sponsor.

this difficult as most private equity firms will want to control the LLC. However, if the independent sponsor can raise capital from a fragmented investor base it may make the negotiations easier.

Throughout my career I have always heard talented private equity managers speak to the importance of training your “LP base” (i.e., investor base). If you can raise capital from the right group of investors and set clear expectations early in your career as an independent sponsor, it will make all subsequent transactions easier to negotiate.